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# Corporate Governance and the Protection of Stakeholder Interests in British Banks

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## 1. INTRODUCTION

The corporate governance of British banks has received considerable attention in recent years from a succession of government inquiries, media reports and academic studies. It is clear that during the global financial crisis banks failed to adequately protect their stakeholders and that some suffered dearly as a result. This calls for more effective mechanisms and new thinking on the protection of these diverse stakeholder interest groups, whether they be shareholders, depositors, employees, other banks supplying credit, or the wider community. A system of networked corporate governance is called for with links between the internal corporate governance arrangements in banks and external regulatory structures, as well as to market mechanism and gatekeepers that need to be energized to operate more effectively as controllers. In this regard, banks may serve as a model for other larger companies as many large companies share many features that are similar to those of banks.

The corporate governance literature identifies a broad range of stakeholders in companies. These interests or stakeholders may be divided between those that are internal to the company and those that are external to it, although the degree of engagement with external stakeholders may be such that their interests can be equally important to the success of the company as the interests of internal stakeholders. This is especially so in regard to banks that are often seen as playing a key role in maintaining the wider market economy and transactions within this market through the supply of credit. My focus in this paper will be upon public limited companies in the United Kingdom and not upon private companies. I will be looking particularly at the corporate governance arrangements within banks and the manner in which stakeholder interests are balanced within these types of companies.

Internal stakeholders include the company's shareholders, its employees, and its creditors. The company's suppliers of goods and

services can also be classified as creditors in some situations, although they might be seen as external stakeholders. In the case of banks, external stakeholders also include a company's customer who plays a critical role in regard to the success of the company. Bank depositors are also important stakeholders, even though they might otherwise be seen as customers. Similarly, other banks can be important stakeholders, as they provide short-term liquidity to keep banks operational. These other banks may be competitors in one sense, but it is clear that competitors may also be seen as a kind of stakeholder.

More broadly, stakeholders also include the government and the community within which the company operates; this effectively means that the governmental regulatory agencies may potentially play an important stakeholder role in many larger companies (such as through industry licensing and the imposition of various regulatory requirements in areas such as health and safety and environmental matters). In the case of banks, the role of government as a stakeholder is especially important.

In regard to banks and financial institutions in the United Kingdom, the provision and removal of banking licenses<sup>1</sup> and the approval of persons as being fit and proper persons to sit on a bank's board of directors is an illustration of the power of these external stakeholders. The UK Financial Services Authority (FSA) has broad powers under the Financial Services and Markets Act 2000 (United Kingdom) over both regulated and unregulated firms and individuals who fail to comply with prescribed market rules.<sup>2</sup> These enforcement powers were recently extended by the Financial Services Act 2010 (United Kingdom), which now empowers the FSA to suspend or restrict authorized and approved persons; persons who conduct controlled functions in the financial sector without appropriate governmental approval may also suffer the imposition of penalties.

This paper explores how stakeholder ideas can be applied to a discussion of the corporate governance of banks and suggests that a much broader range of stakeholders need to be considered when

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1 The provision of new banking licenses is relatively rare in the United Kingdom, with the first new bank license in over 100 years being granted recently to the new Metro Bank; see further, H. Wallop, 'Metro Bank Granted FSA Licence', *The Telegraph*, 5 Mar. 2010.

2 See generally, Financial Services Authority, 'FSA Enforcement Information Guide', October 2010.

thinking about bank governance. This inevitably takes us beyond the narrower range of stakeholders (e.g., shareholders and employees) that tend to dominate discussions of corporate governance in other types of companies. However, banks are important in the development of stakeholder ideas, as they illustrate that we need to go beyond the narrow principal agency model of the corporation that has dominated corporate governance discussions.

More recent thinking about corporate governance has stressed the importance of going beyond these narrow confines and adopting a more networked approach to governance in a knowledge economy, which are captured in phrases such as ‘network governance’ and ‘network regulation’.<sup>3</sup> The power of this wider network model of stakeholderism is especially apparent in regard to banks and is best captured in the idea of ‘contagion’ that is often used in discussing the effects of the instability of one bank upon other banks. It may, however, be useful at this stage to review the development of stakeholder ideas in relation to the governance of corporations.

## 2. THE EMERGENCE OF STAKEHOLDER THEORY

The emergence of stakeholder theory has been a major feature of the business management literature of the last three decades, although the term can be traced back at least to a 1963 internal memorandum at the Stanford Research Institute, which defined stakeholders as ‘those groups without whose support the organization would cease to exist’.<sup>4</sup> In 1983, the management theorist R Edward Freeman published his influential text, ‘Strategic Management – A Stakeholder Approach’, which built upon earlier studies in this area.<sup>5</sup> There is now a voluminous literature dealing with stakeholder management in the modern corporation, but it is beyond the scope of this paper to review this here.<sup>6</sup>

As we have seen, Freeman defined stakeholders as ‘[a]ny group or individual who can affect or is affected by the achievement of the firm’s objectives’.<sup>7</sup> Freeman’s list of such stakeholders included the following: owners, employees, suppliers, customers, competitors, consumer advocates, media, environmentalists, local community organizations and governments. Freeman noted that:

Each of these groups plays a vital role in the success of the business enterprise in today’s environment. Each of these groups has a stake in the modern corporation, hence, the term ‘stakeholder’, and ‘the stakeholder model or framework’ or ‘stakeholder management’.<sup>8</sup>

We could add further groups, such as depositors and competitor banks, when discussing bank stakeholders. Freeman noted that this reality called for new theories or models of how each of these groups work so as to develop a strategy for each group; he added that there was also the need to develop integrated approaches for dealing with these multiple stakeholder groups of the corporation. As he explained, there was a need to consider how each strategic issue affected these stakeholders, creating the need for ‘processes which help take into account the concerns of many groups’.<sup>9</sup> Freeman and McVea subsequently noted that:

A stakeholder approach emphasizes the importance of investing in the relationships with those who have a stake in the firm. The stability of these relationships depends on the sharing of, at least, a core of principles or values.

This was seen as important, as the long-term survival of the firm depended upon a shared set of values, on the one hand, of the corporation and of its managers and, on the other hand, the values of its various stakeholders.<sup>10</sup> Empirical evidence of the link between a set of core values in the company and the long-term success or survival of the company has been identified by a number of other researchers.<sup>11</sup>

This is especially clear when we come to discuss bank governance where a failure to consider wider stakeholder interests in the pursuit of short-term gains (e.g., bonuses) by those controlling banks can undermine the survival of the bank and may trigger wider external intervention in the affairs of banks. In reviewing the rise of what he refers to as ‘the stakeholder corporation’, Clarke has noted that:

Though ascendant in financial circles the shareholder view of the firm has only occasionally enjoyed a strong voluntary commitment

3 See generally in regard to network regulation, J.B. Braithwaite, *Regulatory Capitalism: How It Works, Ideas for Making It Work Better* (Cheltenham: Edward Elgar, 2008); also see S. Turnbull, ‘Network Governance’, *Corporate Governance International* 6, no. 3 (2003): 4–14; and C. Jones, W.S. Hesterly & S.P. Borgatti, ‘A General Theory of Network Governance: Exchange, Conditions and Social Mechanisms’, *Academy of Management Journal* 22, no. 4 (1997): 911–945.

4 Referred to by Freeman in R.E. Freeman, *A Strategic Management – A Stakeholder Approach* (University of Minnesota, 1984), Cambridge University Press (reprint), at 31–32.

5 *Ibid.*, 33–44. Freeman has noted that elements of the stakeholder concept were also developed in the corporate planning literature of the 1960s and in the systems theory literature of the 1970s; the 1980s saw the corporate social responsibility literature build upon the original Stanford Research Institute stakeholder concept by applying the concept to groups who had previously been seen to be in an adversarial relationship with the firm. It might also be noted that organizational theorists from the 1960s also began to look at stakeholder issues, such as the interaction between the organization and the wider environment, which was reflected in the work of William Evan dealing with the notion of the ‘organization set’.

6 See further, A.L. Friedman & S. Miles, *Stakeholders – Theory and Practice* (Oxford: Oxford University Press, 2006); A.J. Zakhem, D.E. Palmer & M.L. Stoll (eds), *Stakeholder Theory* (New York: Prometheus Books, 2008); and R.A. Phillips & R.E. Freeman (eds), *Stakeholders* (Abingdon: Edward Elgar, 2010). Also see T. Donaldson & L.E. Preston, ‘The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications’, *The Academy of Management Review* 20, no. 1 (1995): 65–91.

7 Freeman, 25.

8 *Ibid.*, 25.

9 *Ibid.*, 26.

10 See further, R.E. Freeman & J. McVea, ‘A Stakeholder Approach to Strategic Management’, in *Handbook on Strategic Management*, ed. M.A. Hitt, R.E. Freeman & J.S. Harrison (Oxford: Blackwell, 2001), 189–207, at 195–196.

11 See further, J. Collins & J. Porras, *Built to Last* (New York: Harper, 1994); and A. Svendsen, *The Stakeholder Strategy* (San Francisco: Berrett-Koehler Inc., 1998).

from industrial managers who have to wrestle with the more practical concerns of running a business. In practice, executives leading companies and managers operating them have increasingly utilised elements of the stakeholder approach. The defence of shareholder rights sits uneasily with how increasingly companies are managed.<sup>12</sup>

These practical limitations of the shareholder value concept were illustrated a few years ago by an observation by Jack Welch, the former CEO of one of America's most admired companies, General Electric, who observed in 2009 that a focus merely upon a company's quarterly financial returns was 'the dumbest idea in the world'.<sup>13</sup> This was because, as Welch argued, '[s]hareholder value is a result, not a strategy' and that a company's main constituencies should be seen as its employees, customers and its products.<sup>14</sup>

However, the company or corporate law literature (whether scholarly or judicial) has been slow to embrace stakeholder theory, although American constituency statutes show a limited movement in this direction.<sup>15</sup> Traditionally, the so-called shareholder primacy doctrine prevailed and arguably required that directors seek to maximize the wealth of their members as a whole when making corporate decisions.<sup>16</sup> Thus, the courts have prohibited directors from providing benefits to employees or the community unless this is clearly being done for the benefit of the shareholders.<sup>17</sup>

This was because shareholders had contributed capital and had a residual entitlement to the remaining assets in the event of the company's insolvency. However, governments have increasingly imposed additional layers of monitoring and control in regard to some major corporations, such as banks and insurance companies because of the wider impact that their failure may cause.

Traditional agency theory saw directors as being the agents of the shareholders (although in law they, strictly speaking, were not; this was because directors only had a legal obligation to the company as a whole). Corporate governance arrangements were intended to minimize agency costs and sought to align the interests of managers with those of shareholders. These agency costs referred to the

dangers of directors engaging in shirking behaviour or in self-serving behaviour (such as the diversion of corporate opportunities from the company) at the expense of shareholders.

The provision of adequate remuneration and incentives for management was seen as a way of maximizing benefits for shareholders. This has become a particular public concern in regard to the governance of banks and financial institutions, although we are yet to find an adequate solution to it. Interestingly, shareholders of banks have been prepared to see their senior officers and leading investment managers being very well rewarded financially for their efforts, despite the poor long-term performance of their actions.

The justifications for a narrow shareholder wealth maximization approach (adopted by many corporate law scholars) can be traced back to contractual models of the firm, which has been conceptualized as a nexus of contracts; this model has been built upon the work of economists such as Ronald Coase; the firm was seen as a means of minimizing the transaction costs of the business;<sup>18</sup> this model assumed that shareholders (and others within the firm) entered into contracts, such as employment contracts with managers aimed at providing managers with sufficient incentives so as to maximize returns for shareholders. However, as the economic concept of the firm was always a broader idea than the legal conception of the company, it was not unusual for economists and lawyers to reach different conclusions in this area.

Leading proponents of this value maximization model of the corporation, such as the economist Michael C Jensen, have been critical of stakeholder theory as playing 'into the hands of special interests that wish to use the resources of the corporation for their own ends'.<sup>19</sup> However, and somewhat unexpectedly, the recent global financial crisis has focused critical attention on the dangers of short termism (inherent in shareholder wealth maximization strategies) and has prompted governments and multi-lateral bodies to call for the adoption of longer-term business perspectives in corporations.<sup>20</sup>

The debate about executive remuneration has continued in the guise of calls for shareholders in listed companies to be given a greater say over the pay of directors and senior managers. This debate has

12 T. Clarke, 'The Stakeholder Corporation: A Business Philosophy for the Information Age', in *Theories of Corporate Governance*, ed. T. Clarke (London: Routledge, 2004), 189–201, at 190. Quoting Plender, Clarke (at 200) suggests that: 'a stakeholder approach may be not just a moral imperative, but a commercial necessity "in a world where competitive advantage stemmed more and more from the intangible values embodied in human and social capital"'.  
13 Quoted by F. Gueren, 'A Need to Reconnect', in *The Financial Times* supplement *The Future of Capitalism* (ed. L. Barber), 12 May 2009, 33.  
14 *Ibid.*, 33.  
15 See further, A.R. Keay, 'Moving towards Stakeholderism? Enlightened Shareholder Value, Constituency Statutes and More: Much Ado About Little?', *European Business Law Review* 9 (2011): 1–49.  
16 However, the narrow shareholder primacy doctrine is not without its critics and is arguably not as narrow as its proponents suggest; see further, L.A. Stout, 'New Thinking in "Shareholder Primacy"', UCLA School of Law, Law-Econ Research Paper No. 11-04, <<http://ssrn.com/abstract=1763944>>. Also see A.R. Keay, 'Stakeholder Theory in Corporate Law: Has It Got What It Takes?', *Richmond Journal of Global Law & Business* 9 (2010): 249.  
17 The classic cases on this are *Hutton v. West Cork Rly Co* (1883) 39 Ch D 156 and *Parke v. Daily News Ltd* [1962] Ch 927. Also see generally L. Sealy, 'Directors' "Wider" Responsibilities – Problems Conceptual, Practical and Procedural', *Monash University Law Review* 13 (1987): 164.  
18 Ronald Coase's influential essays on the nature of the firm are to be found (at 18–74) in O.E. Williamson & S.G. Winter (ed.), *The Nature of the Firm: Origins, Evolution and Development* (New York: Oxford University Press, 1993); Also see O.E. Williamson & S.E. Masten (eds), *The Economics of Transaction Costs* (Cheltenham: Edward Elgar Publishing Ltd, 1999); and F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991).  
19 M.C. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', in *US Corporate Governance*, ed. D.H. Chew & S.L. Gillan (New York: Columbia University Press, 2009), 3–25, at 22. Also see generally, J. Argenti, 'Stakeholders: The Case Against', *Long Range Planning* 30, no. 3 (1997): 442; and A. Campbell, 'Stakeholders: The Case in Favour', *Long Range Planning* 30, no. 3 (1997): 446.  
20 Government concerns about the need for greater long-term strategies in UK companies have been reflected in a number of recent public consultations in the United Kingdom.

been linked to repeated calls to demonstrate that the payment of executive remuneration can be explained by improved longer-term performance of their companies. UK Business Secretary Vince Cable has, for some time, been calling for action to limit excessive executive salaries in banks and other enterprises.<sup>21</sup> Too often, companies such as investment banks have rewarded short-term achievement (such as the selling of poor quality securities) without regard to the long-term value of the securities or products that they traded.

This has been seen recently in the United Kingdom with the mis-selling scandal, which saw banks sell billions of pounds of payment protection insurance (PPI) to their borrowers, even though these borrowers were not in the position to claim on these insurance policies. Those writing bank loans to mortgage customers would receive commissions for selling PPI policies, even though these borrowers were unaware of having been sold this additional product.<sup>22</sup> This is reminiscent of banks selling AAA-rated securitized products to investors, even though the quality of assets that have been brought together in these securities was actually quite poor.<sup>23</sup> It also reminds us of the way in which investment banks such as Goldman Sachs have put together portfolios (credit default obligations (CDOs)) for sale to their banking clients, only to then bet against their clients that these CDOs would fail.<sup>24</sup> Prior to the recent financial crisis, banks rewarded their staff for writing massive sub-prime loans such that many of these banks then carried massive toxic loans; in one recent report, the Bank of America reported that it was carrying some USD 850 billion in bad loans of this kind and that it was actively seeking to reduce this burden for the sake of its own survival.<sup>25</sup>

As part of the bargain that was said to serve as the foundation of the agency model of the corporation, directors are given control over decision making in regard to the management of the company, with shareholders being given a reduced number of levers of power, such as the power to appoint or dismiss directors, as well as the right to receive information to evaluate company performance, such as in the company accounts.<sup>26</sup> Increasingly, we have seen calls for

shareholders to be given broader powers to express their views on remuneration packages and major company transactions, such as the disposal of key assets.

Shareholders have also been given more streamlined (although often ineffective) powers to take action against directors in the name of the company where the directors have breached their duties to the company (derivative suits);<sup>27</sup> shareholder also retain the legal power to enforce the terms of the company constitution where this has been breached by another shareholder or by the company.

But because directors do not normally have a duty to shareholders, it is difficult for shareholders in their own right to take action against bank directors for breaching their duties. Collective action problems have meant that shareholders in large widely dispersed shareholder companies often are unable to act in a synchronized way to initiate some forms of shareholder action. The Northern Rock shareholder action seemed to be something of an aberration, as this was brought against the UK government and not against the bank's directors.<sup>28</sup>

Moreover, problems of information asymmetry make it difficult for shareholders to have sufficient information about the company to be able to call directors to account even if they can achieve the necessary majorities to exercise their legal powers. This even applies to larger institutional shareholders who are generally passive in regard to corporate governance issues. The recently promulgated Stewardship Code in the United Kingdom aims to encourage institutional shareholder to be more activist, but this remains problematic.<sup>29</sup>

Some concession to the shareholder primacy model has been made in the recognition of other interests in the company, but largely as a result of statutory intervention; this has usually arisen in insolvency or impending insolvency situations and applies especially to the interests of employees and creditors. It was considered that once a company is nearing insolvency, the unsecured assets of the company should first be available to satisfy claims by creditors and employees and that directors should manage the company having regard to their interests.<sup>30</sup> Also, in a company takeover context, directors are often

21 See further V. Cable, 'Call the Bankers' Bluff', *New Statesman* (20 Feb. 2009); More recently, Cable has foreshadowed new legislation in this area; see further 'UK could legislate to curb excessive pay – Cable', *Reuters*, 14 Nov. 2011, <<http://uk.reuters.com/article/2011/11/14/uk-britain-cable-idUKTRE7AD02F20111114>>.

22 See further J. Treanor & G. Wearden, 'FSA Tells Banks to Speed Up PPI Compensation', *The Guardian* 10 May 2011, at 22.

23 See generally G. Tett, *Fool's Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe* (London: Little Brown, 2009). Also see P. Augar, *Chasing Alpha: How Reckless Growth and Unchecked Ambition Ruined the City's Golden Decade* (London: Bodley Head, 2009); and P. Augar, *The Greed Merchants: How the Investment Banks Played the Free Market Game* (London: Penguin Books, 2006).

24 This led to a US Securities and Exchange Commission action being brought Goldman Sachs (ultimately being settled by the imposition of a heavy fine); see further *Securities and Exchange Commission v. Goldman Sachs & Co and Fabrice Tourre* 10 Civ. 3229 (BJ) (S.D.N.Y April 16, 2010). Also see C. Harper & R. Schmidt, 'Goldman Deserves Regulatory Probe, Bloomberg Poll Says', *Bloomberg* 8 Jun. 8 2010, <[www.bloomberg.com/news/2010-06-07/goldman-sachs-deserves-scrutiny-by-regulators-in-bloomberg-subscriber-poll.html](http://www.bloomberg.com/news/2010-06-07/goldman-sachs-deserves-scrutiny-by-regulators-in-bloomberg-subscriber-poll.html)>.

25 See further S. Kapner & J. Baer, 'BoFA Plans to Halve Its \$850 bn in Bad Loans', *The Financial Times*, 10 May 2011, at 22.

26 See further A. Keay, *Directors' Duties* (Bristol: Jordan Publishing, 2008).

27 See generally A. Reisberg, 'Derivative Claims under the Companies Act 2006: Much Ado About Nothing?', in *Rationality in Common Law: Essays in Honour of DD Prentice*, ed. J. Armour & J. Payne (Oxford: Hart Publishing, 2009), 17–55; A.R. Keay & J.M. Loughrey, 'Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action under the Companies Act 2006', *The Law Quarterly Review* (2008): 469.

28 See further R. Tomasik, 'Shareholder Litigation and the Financial Crisis: The Northern Rock Shareholder Appeal Considered', *Company Law Newsletter* 262 (29 Oct. 2009): 1–5.

29 See generally B. Cheffins, 'The Stewardship Code's Achilles' Heel', *Modern Law Review* 73 (2010): 1004–1025; A. Reisberg, 'The Notion of Stewardship from a Company Law Perspective: Re-defined and Re-assessed in Light of the Recent Financial Crisis?', *Journal of Financial Crime* 18, no. 2 (2011): 126–147; L. Roach, 'The UK Stewardship Code', *Journal of Corporate Law Studies* 11, no. 2 (2011): 463–493.

30 See generally J.S. Ziegel, 'Creditors as Corporate Stakeholders – The Quiet Revolution – An Anglo-Canadian Perspective', *University of Toronto Law Journal* 43 (1993): 511; A.R. Keay, 'Formulating a Framework for Directors' Duties to Creditors: An Entity Maximization Approach', *The Cambridge Law Journal* 64 (2005): 614; and A.R. Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-protection of Creditors', *The Modern Law Review* 66 (2003): 665.



said to have a broader responsibility than merely serving the wealth maximization interest of the current shareholders.<sup>31</sup> This is presumably even more so in regard to more complex institutions, like banks, due to the systemic importance attributed to them.

An increasing body of progressive legal scholars has challenged the narrow economic thinking behind the shareholder primacy model and has called for a broadening of legal thinking about the use of stakeholder ideas. Probably the most influential of these writings have been those of writers such as Blair and Stout who have advocated the 'team production' model of the corporation in which the board was seen as a mediating hierarchy between diverse groups of stakeholders within the corporation.<sup>32</sup> This 'new' thinking<sup>33</sup> has influenced recent company law reforms in the United Kingdom, as will be discussed below. Banks themselves have been subject to unprecedented scrutiny in recent times, leading to more onerous expectations being expected of the backgrounds and experience of directors, as evidenced in the findings of the Walker review into directors of UK banks and financial institutions.<sup>34</sup> The Final Report of the UK Independent Commission on Banking (the Vickers Commission) has also recommended 'ring fencing' the normal utility side of banking so as to protect it from the riskier investment banking operations of banks.<sup>35</sup> However, debate continues over the introduction of these reforms with the UK government having proposed to postpone this until 2019, whilst critics argue that this should not be delayed for more than two years.<sup>36</sup>

### 3. RECENT DEVELOPMENTS IN STAKEHOLDER LAW IN THE UNITED KINGDOM

In 2006, the United Kingdom enacted a new Companies Act, which is notable for a number of major company law reforms. One of these was the attempt to displace the idea of shareholder wealth maximization with the new concept of 'enlightened shareholder value'. This new idea sought to encourage directors when making decisions to

have regard for the long-term success of the company. In doing so, it sought to impose a legal obligation upon directors to have regard to the interests of a number of other company stakeholders.

This intention was expressed in the form of section 172(1) of the UK Companies Act, which provides that:

#### 172 Duty to promote the success of the company

- (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
  - (a) the likely consequences of any decision in the long term,
  - (b) the interests of the company's employees,
  - (c) the need to foster the company's business relationships with suppliers, customers and others,
  - (d) the impact of the company's operations on the community and the environment,
  - (e) the desirability of the company's maintaining a reputation for high standards of business conduct, and
  - (f) the need to act fairly between members of the company.

This is not an exhaustive list of interests. Section 172(3) preserves the position of creditors and provides that section 172(1) is to be read as being subject to any other enactment or rule of law, which requires that directors should act in the interests of creditors in some circumstances, such as where insolvency has occurred or is likely. In other words, shareholders will still enjoy priority over claims by creditors, except in situations of impending insolvency.<sup>37</sup> In the event of actual insolvency, unsecured creditors will rank ahead of shareholders under the old common law *Rule in Houldsworth* case,<sup>38</sup> which established the shareholder subordination principle. This rule is now reflected in the United Kingdom in section 655 of the Companies Act 2006.<sup>39</sup>

31 However, the adoption of a narrow shareholder wealth maximization approach in the recent Cadbury takeover in the United Kingdom led to considerable employee and government concerns and call for a review of UK takeover rules.

32 See further M.M. Blair & L.A. Stout, 'A Team Production Theory of Corporate Law', *Virginia Law Review* 85, no. 2 (1999): 247–328; also see M.M. Blair & L.A. Stout, 'Director Accountability and the Mediating Role of the Corporate Board', *Washington University Law Quarterly* 79 (2001): 403. Also see M.M. Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century', in *Theories of Corporate Governance*, ed. T. Clarke (London: Routledge, 2004), 174–188.

33 It should, however, be noted that a parallel (if not identical) perspective on corporate governance can be found in the debate between A.A. Berle and E.M. Dodd; see further E.M. Dodd, 'For Whom Are Corporate Managers Trustees?', *Harvard Law Review* 45 (1932): 1145–1163; A.A. Berle, 'For Whom Corporate Managers Are Trustees: A Note?', *Harvard Law Review* 45 (1932): 1365–1372. However, this debate, which followed the Great Depression of 1929, was set in a different context, and it would be wrong to cast Berle as the ancestor of present-day shareholder primacy advocates or to see Dodd as the procurer of contemporary stakeholder or corporate social responsibility movement; see further W.W. Bratton & M.L. Wachter, 'Shareholder Primacy's Corporatist Origins: Adolf Berle and "The Modern Corporation,"' <<http://ssrn.com/abstract=1021273>>.

34 See further D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, Final Recommendations*, 26 Nov. 2009, <[http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/walker\\_review\\_information.htm](http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/walker_review_information.htm)>.

35 Independent Commission on Banking, *Final Report, Recommendations*, September 2011, London, at 35 ff, <<http://bankingcommission.independent.gov.uk/>>.

36 J. Treanor, 'Vickers Report: Banks Get until 2019 to Ringfence High Street Operations', *The Guardian* 12 Sep. 2011, <[www.guardian.co.uk/business/2011/sep/12/vickers-report-banks-given-until-2019](http://www.guardian.co.uk/business/2011/sep/12/vickers-report-banks-given-until-2019)>; and R. Jenkins, 'Bank Reform Can't Wait', *The Guardian*, 14 Nov. 2011, <[www.guardian.co.uk/commentisfree/2011/nov/14/bank-reform-cant-wait-until-2019/print](http://www.guardian.co.uk/commentisfree/2011/nov/14/bank-reform-cant-wait-until-2019/print)>.

37 See generally, A. Keay, *Company Directors' Responsibilities to Creditors* (London: Routledge, 2007).

38 *Houldsworth v. City of Glasgow Bank* (1880) 5 App Cas 301. See also the more recent statement of law in this area in *Soden v. British and Commonwealth Holdings plc* [1997] 2 BCLC 501, HL.

39 Similar legislative provisions are to be found in other jurisdictions, such as in s. 536A of the Australian Corporations Act; for a review of this area of law, also see generally Corporations and Markets Advisory Committee, *Shareholder Claims Against Insolvent Companies – Implications of the Sons of Gwalia Decision*, Sydney, CAMAC, December 2008, <[www.camac.gov.au/camac/camac.nsf/0/3DD84175EFBAD69CCA25B6C007FD4E8?opendocument](http://www.camac.gov.au/camac/camac.nsf/0/3DD84175EFBAD69CCA25B6C007FD4E8?opendocument)>.

Section 172(1), therefore, contains a number of elements that are relevant to the adoption of a more stakeholder oriented approach by directors. These are most evident in the considerations that are set out in sub-sections (b) to (d) of the section. The section potentially applies to a wider range of stakeholders than those mentioned in the section. Particular attention is given to the company's employees, its suppliers and customers, the community and the environment.

However, there may be other types of stakeholders that should be considered; this will depend on the particular circumstances of the company. Creditors are, as we have seen, also recognized, but curiously, they are not listed as a stakeholder in section 172(1). But what is striking about section 172(1) is that in its first few lines it prioritizes the interests of shareholders when it states that, when directors seek to promote the success of the company, this should be done 'for the benefit of the members as a whole'.

In this context, the members of the company are to be understood as its shareholders. However, the term 'shareholder' is somewhat misleading, wherein it is assumed that shareholders hold a share of the assets of the company; the term 'member' is probably more appropriate. Furthermore, companies may not be limited by shares and so may not issue shares as such.

Agency theory, as developed by economists, has, however, been dominated by a property rights conception of shareholders. But, in law, shareholders do have participation rights and do own a share of the rights to participate in the company, such as the right to vote, to attend meetings and to participate in the distribution of dividends and in any residue that may exist if the company is wound up.<sup>40</sup>

In discharging their duties under section 172, directors are subject to various constraints. First, they are required to act in 'good faith' when making decisions, and section 172(1)(f) also requires them to act fairly as between the company's members. Second, directors who exercise their role as required by section 172 are also subject to the reasonable skill, care and diligence requirements (which apply to the making of decisions) found in section 174 of the Companies Act. To avoid a charge that directors did not act with skill or with reasonable care and diligence, they should document their decisions to show that they did have regard to or consider the matters set out in this section.

A major difficulty with the duties set out in section 172 is that it is not possible for any group other than the members or shareholders to enforce the duty; this was because either the shareholders bring a derivative action or the company itself sues for the breach. Employees, for example, do not have standing under the Companies Act to sue directors for their failure to comply with section 172.

However, section 247 of the Act permits directors to provide for employees or former employees of the company where the company ceases business or transfers the whole or a substantial part of its business. This power can be exercised even if the decision to make a provision under section 247 will not promote the success of the company, as required by section 172.<sup>41</sup> So employees are given some further protection.

We have also noted that creditors, as a group, are also subject to particular protection, as their interests will take priority over those of shareholders in an insolvency or at least until the company's debts have been discharged. This principle is supported both by common law cases as well as by other legislation, such as in section 214 of the Insolvency Act, which deals with wrongful trading by directors.<sup>42</sup> Creditors can, of course, seek to strengthen their position further by the use of pre-packaged arrangements with debtors or by inserting clauses into loan agreements that trigger an early resort to the appointment of an insolvency administrator, such as a liquidator, in the event of the clause being breached.

Section 172 requires that directors act in good faith and that they should 'have regard' to the interests or purposes set out in the section. The idea of 'having regard to' might be seen as taking account of various matters and does not mean that the matters must be given priority; it presumably at least requires serious consideration to be given to these other interests. It should thus be noted that there is a distinction between taking account of a number of interests when making decision and being accountable to these interests.<sup>43</sup> Section 172 clearly falls short of any accountability to these other interests. However, this narrow view of accountability may need to be revised in a world where the major assets of a company are often the knowledge and skills of its employees, rather than the capital contributed by a company's shareholders. This is especially so in financially oriented companies such as banks.

In addition to possible action for a breach of the care and diligence rules, the Companies Act seeks to strengthen the effect of the stakeholder principles in section 172 by requiring directors to prepare a 'business review' under section 417, which requires that directors of larger companies must provide an annual report on the way in which they have sought to conduct the business. As section 417(2) states, the 'purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty under section 172 (to promote the success of the company)'. In regard to stock exchange listed or quoted companies, they also need to set out various key performance indicators (as required by section 417(6)) and set out

40 See generally, A. Dignam & J. Lowry, *Company Law*, 6th edn (Oxford: Oxford University Press, 2010), at para. 2.33.

41 *Ibid.*, para. 329.

42 See further, *ibid.*, 329–331.

43 For an expression of such a view, see further J. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Countries* (Oxford: Clarendon Press, 1994), at 36.

details of how stakeholder concerns have been addressed. Thus, section 417(5) requires that:

417(5) In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include –

- (a) The main trends and factors likely to affect the future development, performance and position of the company's business; and
- (b) Information about
  - (i) environmental matters (including the impact of the company's business on the environment),
  - (ii) the company's employees, and
  - (iii) social and community issues,including information about any policies of the company in relation to those matters and the effectiveness of those policies; and
- (c) subject to subsection (11), information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

If the review does not contain arrangements of each kind mentioned in paragraphs (b)(i), (ii) and (iii) and (c), it must state which of those kinds of information it does not contain.

Prior to the enactment of these new provisions, the UK government even considered more rigorous disclosure requirements, in the form of an Operating and Financial Review, but these were dropped prior to the passage of the 2006 Companies Act.<sup>44</sup> However, the current coalition government has been considering the reintroduction of more detailed narrative reporting.<sup>45</sup>

The enactment of the Companies Act 2006 brings to a close a decade-long debate in the United Kingdom about the desirability of introducing stronger stakeholder rules into British company law.<sup>46</sup> Reactions to the new legislative provisions have been mixed, with academic commentators being somewhat sceptical of their likely effectiveness<sup>47</sup> and judicial commentators suggesting

that this restatement does not go much further than earlier provisions.<sup>48</sup>

However, the promotion of the best long-term interests of the company or what has been described as the 'enlightened shareholder value' approach that is reflected in section 172, at least sends an important signal that it is in the company's interests for its directors to consider other interests as well as those of shareholders.<sup>49</sup> There has, for some time, been a statutory requirement that directors should take into account the interests of employees,<sup>50</sup> although directors were not bound to give priority to the interests of employees over those of shareholders.<sup>51</sup> What is clear from the above discussion is that there has been a clear public policy movement to recognize wider stakeholder concerns and to seek to protect them. However, it is still too early to see how these new legislative provisions will be applied and developed by British courts. As they stand, these provisions are probably more symbolic than real due to the loose language in which they are expressed.<sup>52</sup>

#### 4. EFFECTS OF THE GLOBAL FINANCIAL CRISIS ON GOVERNANCE OF UK BANKS

A major factor in opening up the legal and policy debate in this area has been the effect of the global financial crisis. This has seen much attention being devoted to poor corporate governance practices in banks and financial institutions, such as from the Organisation for Economic Co-operation and Development.<sup>53</sup> In a series of UK reports and inquiries, questions have been asked about the adequacy of previous methods of dealing with stakeholder concerns. Even shareholders were found to be relatively weak in seeking that the controllers of their companies took longer-term views.

This provoked the recent Walker review into fiduciary duties in banks and financial institutions to call for enhanced of institutional shareholder activism and recommended the introduction of a Stewardship Code, which has now been developed by the UK Financial Reporting Council. However, its effectiveness is likely to be questionable given the costs that shareholder activism entails.<sup>54</sup> Moreover, Walker was critical of efforts to impose wider statutory duties upon

44 See further C.A. Williams & J.M. Conley, 'Triumph or Tragedy? The Curious Path of Corporate Disclosure Reform in the UK', *William & Mary Environmental Law and Policy Review* 31 (2007): 317.

45 See further Department for Business Innovation & Skills, 'The Future of Narrative Reporting: A Consultation', 2 Aug. 2010, <[www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation](http://www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation)>.

46 See generally J. Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford: Clarendon Press, 1993); and J. Parkinson, A. Gamble & G. Kelly (eds), *The Political Economy of the Company* (Oxford: Hart Publishing, 2001).

47 Keay, 2011, and A.R. Keay, 'The Duty to Promote the Success of the Company: Is It Fit for Purpose?' (20 Aug. 2010), University of Leeds School of Law, Centre for Business Law and Practice Working Paper, <<http://ssrn.com/abstract=1662411>>.

48 In the 2008 decision in *Re Southern Counties Fresh Foods Ltd* [2008] EWHC 2810, the court compared the new provision of s. 172 with the pre-existing common law and concluded that they were not very different for the expression of these duties in *Re Smith & Fawcett Ltd* [1942] Ch. 304. See also discussion in Dignam & Lowry, 328–329; also see Arden, The Rt Hon Lady Justice, 'Companies Act (2006): A New Approach to Directors' Duties', *Australian Law Journal* 81 (2007): 162; and Arden, The Rt Hon Lady Justice, 'Regulating the Conduct of Directors', *Journal of Corporate Law Studies* 10, no. 1 (2010): 1–15.

49 The common law had already been moving in this direction as is evident from the Canadian Supreme Court case of *People's Department Stores v. White* [2004] SCR 461.

50 See s. 309 of the 1985 Companies Act (UK).

51 See further Dignam & Lowry, para. 14.35.

52 This symbolic approach may be compared to the introduction of the Sarbanes-Oxley Act after the Enron collapse; see further J. O'Brien, 'The Politics of Symbolism: Sarbanes-Oxley in Context', in *International Corporate Governance After Sarbanes-Oxley*, ed. P.U. Ali & G.N. Gregoriou (Hoboken: John Wiley & Sons, Inc., 2006), 9–25.

53 G. Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis', *Financial Market Trends* (2009): 1, Paris, OECD, 2009.

54 For a more detailed analysis of this code, see Cheffins, 985; Reisberg, 2011; and Roach.



directors, which would require them to have regard to stakeholder interests beyond those of the shareholders. As he observed in his final report:

The directors' primary duty to shareholders may on occasion appear to conflict with the interests of other stakeholders such as employees in the case of a proposed divestment or an acquisition that may involve job losses as part of the generation of synergies... To dilute the primacy of the duty of the BOFI director to shareholders to accommodate a new accountability to other stakeholders would risk changing fundamentally the contractual and legal basis on which the UK market economy operates.<sup>55</sup>

The financial crisis showed how poorly protected many stakeholder groups in banks were. Not only did many depositors fear that their savings would be lost (forcing the government to tighten the depositor protection regime), but shareholders suffered as well. The shareholders in Northern Rock plc, for example, lost their case against the government when the failed bank was nationalized and the subsequent valuation of their shares left them financially ruined.<sup>56</sup> In a wide-ranging review of the causes of the financial crisis by the Chairman of the UK FSA, Lord Adair Turner pointed to the failure of market discipline in the quantification of market risks.<sup>57</sup>

It was recognized that both internal and external protection of stakeholder interests in British banks was deficient. The House of Commons inquiry into the failure of Northern Rock bank was especially critical of the failure of the directors of this bank to control risk.<sup>58</sup> The subsequent Walker review called for wide-ranging improvements in the performance of bank directors and led ultimately to revisions of the rules now found in the UK Corporate Governance Code.<sup>59</sup>

But a key issue arising out of the banking crisis, namely the remuneration of bank officers and the need for better schemes for the monitoring and approval of these regimes, has largely remained unresolved. The UK's Companies (Summary Financial Statement) Regulations 2008 provide that a summary financial statement must be prepared by companies and that this should set out the aggregate

amount of directors' emoluments. Shareholders who received a summary financial statement are able to vote on this report.<sup>60</sup> Arguably, employees should also be able to be represented on a company's remuneration committee, as a recent House of Commons report suggested.<sup>61</sup> The Commons Treasury Committee observed that:

We found that bonus-driven remuneration structures encouraged reckless and excessive risk-taking and that the design of bonus schemes was not aligned with the interests of shareholders and the long-term sustainability of the banks. We express concern that the Turner Review [by the chairman of the FSA] downplays the role that remuneration played in causing the banking crisis and question whether the Financial Services Authority has attached sufficient priority to tackling remuneration in the City. The banking crisis has exposed serious flaws and shortcomings in remuneration practices in parts of the banking sector and, in particular, within investment banking.<sup>62</sup>

The Treasury Committee concluded that:

Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks.<sup>63</sup>

Existing remuneration rules provide a limited degree of company disclosure in regard to remuneration, but there is still much room for further improvement given the massive rise in executive remuneration in recent years.<sup>64</sup> In the meantime, the UK government has been entering into agreements with leading UK banks in regard to their remuneration disclosure policies for their highest-paid officers. By 2012, it is proposed to introduce mandatory remuneration disclosure rules for major banks.<sup>65</sup> UK public companies are now required to

55 Walker. See further <[www.hm-treasury.gov.uk/walker\\_review\\_information.htm](http://www.hm-treasury.gov.uk/walker_review_information.htm)>, at 137.

56 For a discussion of this litigation by shareholders, see generally Tomasic, 'Shareholder Litigation and the Financial Crisis', 2009, <<http://ssrn.com/abstract=1636430>>.

57 A. Turner, Lord, *The Turner Review – A Regulatory Response to the Global Banking Crisis* (London: Financial Services Authority, March 2009), at 44–47.

58 See generally House of Commons, Treasury Committee, *The Run on the Rock; Fifth Report of Session 2007–08, Volume I, Report, together with Formal Minutes*, The House of Commons, 24 Jan. 2008, <[www.parliament.the-stationery-office.co.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf](http://www.parliament.the-stationery-office.co.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf)>. Also see Independent Commission on Banking (Vickers Commission) *Interim Report*, April 2011, <<http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf>>.

59 See further Financial Reporting Council, *The UK Corporate Governance Code*, June 2010, at 7, <[www.frc.org.uk/documents/pagemanager/Corporate\\_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf](http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf)>.

60 For an excellent summary of these rules and regulations, see further Freshfields Bruckhaus Deringer, 'Directors' Remuneration Report Regulations, Checklist, Commentary and Related Best Practice', 1 Nov. 2010, <[www.freshfields.com/publications/pdfs/2010/nov10/29355.pdf](http://www.freshfields.com/publications/pdfs/2010/nov10/29355.pdf)>.

61 Treasury Committee, House of Commons, *Banking Crisis: Reforming Corporate Governance and Pay in the City*, Ninth Report of Session 2008–2009, 12 May 2009, at para. 77.

62 *Ibid.*, 3.

63 *Ibid.*, 15.

64 For some critical assessments of this area, see further C. Villiers, 'Controlling Executive Pay: Institutional Investors or Distributive Justice?', *Journal of Corporate Law Studies* 10, no. 2 (2010): 309–342; G. Ferrarini, N. Maloney & M.-C. Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', *Journal of Corporate Law Studies* 10, no. 1 (2010): 73–118.

65 H.M. Treasury Press Release 17/11, 9 Feb. 2011, <[www.hm-treasury.gov.uk/press\\_17\\_11.htm](http://www.hm-treasury.gov.uk/press_17_11.htm)>.

prepare remuneration reports and to allow their shareholders to vote on these reports at annual general meetings, but only in an advisory capacity. However, this has fallen short of giving shareholders and other stakeholders an adequate say on remuneration paid to senior executives. The scheme was criticized by the Commons Treasury Committee in its report on remuneration when it stated:

The banking crisis has exposed serious flaws and shortcomings in remuneration practices in parts of the banking sector and, in particular, within investment banking. Whilst the causes of the present financial crisis are numerous and diverse, it is clear that bonus-driven remuneration structures prevalent in the City of London as well as in other financial centres, especially in investment banking, led to reckless and excessive risk-taking. In too many cases the design of bonus schemes in the banking sector were flawed and not aligned with the interests of shareholders and the long-term sustainability of the banks.<sup>66</sup>

The interim report of the recently appointed Vickers review into UK banks has also been critical of remuneration practices and noted that:

Weaknesses in the capital and accounting frameworks prior to the crisis enabled some bank employees to be remunerated on the basis of reported profits that were neither time-adjusted nor risk-adjusted and led to employee incentives that were not always aligned with the long-term interests of the bank. The Financial Services Authority first introduced its Remuneration Code in August 2009 to address these issues. A revised Code came into effect in January 2011 to take account of provisions on remuneration contained in the amendments to the Capital Requirements Directive.<sup>67</sup>

The Vickers Commission proposal to separate utility from investment banking will presumably impose more market discipline and have an effect on the quality of corporate governance and on the kinds of risk taking that has occurred in recent times.<sup>68</sup> In discussing one of the causes of the financial crisis, the Turner Review noted in 2009 that:

The very complexity of the mathematics used to measure and manage risk, moreover, made it increasingly difficult for top management and boards to assess and exercise judgement over the risks being taken. Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (e.g. rapid credit extension and balance sheet growth) could be safely ignored.<sup>69</sup>

The global financial crisis has generated a new debate on the state of corporate governance in UK banks, which is challenging many established practices and views. However, it is too soon to say whether it will lead to further advances in our approaches to dealing with stakeholders in banks. There has clearly been some resistance to this occurring, but the degree of public anger about the losses suffered by UK banks, which led to the full or partial government ownership of many of these institutions, will keep this debate alive for sometime yet. However, we have at least seen the abandonment of the weak style of regulation over British banks following the embarrassing performance of the FSA in the regulation of Northern Rock plc and other banks.<sup>70</sup>

## 5. WHY BANKS ARE DIFFERENT

It is often said that banks are special or that they are different. To some degree this is true because of the damage that big banks can cause to the wider society and to other participants in the market when they fail. But, major threats are also posed by other companies, such as those that operate utilities such as nuclear power generating plants (as we saw in Japan after the recent tsunami) and oil companies (as we recently saw with the oil spill in the Gulf of Mexico). But, for some reason, the corporate governance of banks receives much greater attention from legal scholars and the public than these other kinds of risk.<sup>71</sup>

In part, this is due to the nature of governance arrangements that have been developed to protect stakeholders in banks. It is also due to the inherent instability of markets.<sup>72</sup> Following the recent financial crisis, we have seen the enactment of special resolution rules for the handling of bank in financial difficulties<sup>73</sup>; whilst these are to some extent similar to normal corporate insolvency rules, they are also different in some important respects. This was evident in the United Kingdom with the passage of the new Banking Act 2009.<sup>74</sup>

66 Treasury Committee, House of Commons, *Banking Crisis: Reforming Corporate Governance and Pay in the City*, Ninth Report of Session 2008–2009, 12 May 2009, para. 151.

67 Independent Commission on Banking, *Consultation on Reform Options, Interim Report*, April 2011, at 178.

68 In the United States, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which came into effect on 21 Jul. 2010) has also introduced the Volker Rule, which will seek to deal with the problem of risk-taking by bank by prohibiting them from engaging in proprietary trading on their own account as well as prohibiting banks from owning or investing in funds such as private equity funds and hedge funds. These rules are proposed to be implemented in July 2012.

69 Turner, 22.

70 R. Tomasic, 'Beyond "Light Touch" Regulation of British Banks after the Financial Crisis', in *The Future of Financial Regulation*, ed. I. MacNeil & J. O'Brien (Oxford: Hart Publishing, 2010).

71 See generally, J.R. Macey and M. O'Hara, 'The Corporate Governance of Banks', *FRBNY Economic Policy Review* (April 2003), 91.

72 See further H.P. Minsky, *Stabilizing and Unstable Economy* (New York: McGraw Hill, 2008).

73 See generally, for a discussion of the special nature of bank facing solvency problems, E.H.G. Hupkes, *The Legal Aspects of Bank Insolvency: A Comparative Analysis of Western Europe, the United States and Canada* (The Hague: Kluwer Law International, 2000).

74 For a discussion of this legislation, see further R. Tomasic, 'Creating a Template for Banking Insolvency Law Reform after the Collapse of Northern Rock: Part 1', *Insolvency Intelligence* 22, no. 5 (2009): 65–70; 'Creating a Template for Banking Insolvency Law Reform after the Collapse of Northern Rock: Part 2', *Insolvency Intelligence* 22, no. 6 (2009): 81–88.

Stakeholders in banks have two broad sets of governance and regulatory mechanisms to protect them. As corporations, banks have many of the usual board-based corporate governance mechanisms that apply to other large companies, but these are often weakened in banks.<sup>75</sup> As a result banks are also subject to an unusual amount of external regulation, at least, when compared to other companies and need.

However, in itself, this is not enough, and private investors need to play a greater role in influence governance processes in banks. But markets themselves have been found to be an inadequate means of regulating banks. A particular problem faced by banks was the failure of rating agencies, which served as gatekeepers for investment banks, and rated securitized assets, which were packaged for sale to investors. Due to serious conflicts of interests facing these gatekeepers, they failed to adequately protect stakeholders who relied upon their ratings.<sup>76</sup>

As it turned out, both of internal (board and shareholder) and external (governmental) governance mechanisms failed prior to the global financial crisis and have been the subject of considerable reworking. In particular, a more effective system of prudential regulation has been developed to deal with the risks that can face financial institutions such as banks. Nevertheless, it is widely recognized that this system of external regulation can be important for the protection of bank stakeholders.

As Alexander has observed financial regulation can play an important role in representing stakeholder interests, such as those of consumers of financial services and depositors in banks.<sup>77</sup> As Alexander points out, bank managers are subject to different types of risks, and so the principal agency problem around which many corporate governance rules have been built. As he explains:

a major challenge for corporate governance as it relates to banks and financial institutions involves a redefinition of the principal-agent problem to include the various types of market failure that cause financial instability in the banking sector. This means that banking regulation should be concerned not only with creating an incentive framework to induce management to achieve the objectives of the bank owners (e.g. shareholder wealth maximization), but also to allow the regulator to balance interests of the various stakeholder group in the economy that are affected by bank risk-taking and reduce the social costs that are inevitably associated with poorly regulated banking activity.<sup>78</sup>

As a result, the UK FSA has developed a series of high-level principles for the regulation of banks; these principles include principles of skill, care and diligence of regulated persons in banks.<sup>79</sup> The 2008 Global Financial Crisis has shown that many of the protective governance mechanism that had been built up within and around banks were severely tested, and many were found wanting.

The failure to protect bank stakeholders occurred at three levels. First, it arose within the internal structures of banks (such as with poorly qualified board of directors and docile institutional shareholders). This has been well documented in regard to failures at Northern Rock and in other banks such as RBS. Internal control mechanisms such as risk assessors also failed as they were effectively sidelined by the more profitable cost centres that banks depended upon for their profits; this was most effectively illustrated in HBOS, a bank which went so far as to remove its risk manager, Paul Moore.<sup>80</sup>

Moore told a House of Commons committee of inquiry that the 'balance and separation of powers [in HBOS] was just too far weighted in favour of the CEO and their executives'.<sup>81</sup> This is a reflection of the fact that, in booming markets, those who seek to urge caution often find it hard to be heard by controllers who are in the thrall of more profitable departments in their banks. This may suggest that risk managers should be better protected and better positioned within corporate organizational structures, if they are to be effective.

Second, failure to protect stakeholders also arose in so far as external regulators (such as the UK FSA and the Bank of England) were concerned. Indeed, the FSA's own damning internal report on its regulation of Northern Rock is an illustration of this. But this regulatory failure also extended to international financial regulatory bodies.

Third, independent gatekeepers, such as rating agencies and financial and legal advisers such as auditors and corporate lawyers, also failed to act as effective constraints upon excessive leverage and risk taking on the part of banks.<sup>82</sup> Given the international nature of financial markets, banks are also subject to international banking regulatory mechanisms that broaden even further the range of concerns that boards need to be sensitive to.<sup>83</sup>

The efforts by the banking sector to protect stakeholder interests have proved to be less than adequate. However, they have shown how important a variety of arrangements can be, so long as individual governance mechanisms do not opt out of their responsibilities in the belief that other governance and regulatory bodies will fill the gap. A

75 See generally R. Levine, 'The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence', September 2004, World Bank Policy Research Working Paper No. 3404, <<http://ssrn.com/abstract=625281>>.

76 See further J.C. Coffee, 'What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis', *Journal of Corporate Law Studies* 9 (2009): 1.

77 See further K. Alexander, 'Corporate Governance and Banks: The Role of Regulation in Reducing the Principal-Agent Problem', *Journal of Banking Regulation* 7 (2006): 17–40.

78 *Ibid.*, 21.

79 For a discussion of these principles and regulatory procedures, see Alexander, 30–33.

80 J. Treanor & S. Bowers, 'I Was Sacked for Exposing Risks, Says Bank Whistleblower', *The Guardian*, 11 Feb. 2009, <[www.guardian.co.uk/business/2009/feb/11/hbos-banking](http://www.guardian.co.uk/business/2009/feb/11/hbos-banking)>.

81 Treasury Committee, House of Commons, *Banking Crisis: Dealing with the failure of the UK Banks*, HC 416, (London: The Stationery Office Limited, 2009), at 24–25.

82 See further J. Loughrey.

83 See generally H.M. Schooner & M.W. Taylor, *Global Bank Regulation – Principles and Policies* (Elsevier, 2010).

networked approach to corporate governance arguably can be a valuable approach to protecting stakeholders in complex corporate settings. Space does not permit a fuller elaboration of this theme here.<sup>84</sup>

## 6. CONCLUSIONS

This paper has sought to examine some key issues in the UK literature regarding the protection of stakeholder interests and to link this especially to banks. It was found that good stakeholder management was an important means of ensuring the long-term success and survival of companies.

However, in recent years, short-term policies and incentives have arguably undermined the achievement of longer-term goals, especially in banks. The challenge for reformers is to construct a range of inter-linked corporate regulatory structures that act as a safety net in times of crisis and are able to deal with stakeholder concerns early enough to be resolved.

Because bank failure has the potential to cause considerable damage to a broad range of stakeholders, as well as to the wider market system, adequate stakeholder management and regulation is required. This calls for the involvement of a wider range of stakeholders with internal monitoring and control mechanisms in banks than has occurred to date in the United Kingdom.

Legal mechanisms are an important means of strengthening a commitment to stakeholder values, but by themselves, these will not be enough as a commitment to stakeholder values needs to be part of the culture of banks.

The frequency of bank failures illustrates their vulnerability and calls for new thinking about their governance mechanisms in the United Kingdom. This paper has sought to examine some ideas that may lead to the development of more effective risk management and stakeholder protection in UK banks.

<sup>84</sup> See generally R. Tomasic & F. Akinbami, 'Towards a New Corporate Governance after the Global Financial Crisis', *International Company and Commercial Law Review* 22, no. 8 (2011): 237–249.